

# ALTERNATIVE FINANCE: DRAFT LEGISLATION AND EXPLANATORY NOTE

H M Revenue & Customs are publishing for comment a draft of legislation on alternative finance that it is proposed to include in the Finance Bill 2007. The legislation extends the scope of the legislation in Finance Act 2005, which deals with alternative finance arrangements, to cover alternative finance investments bonds.

Comments on the draft legislation are welcome. They should be made, preferably by email, to:

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Any comments sent by post should be addressed to Tony Sadler or Lesley Hamilton, H M Revenue & Customs, 3<sup>rd</sup> floor, 100 Parliament Street, London SW1 2BQ.

If comments are to be taken into account in considering whether any changes to the legislation are needed before publication of the Finance Bill, they must be received by 5 pm on Friday 23 March.

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## 1. DRAFT LEGISLATION

### Alternative finance: alternative finance investment bond

(1) After section 48 of FA 2005 (arrangements giving rise to alternative finance return) insert

#### **48A Alternative finance arrangements: alternative finance investment bond: introduction**

(1) Subject to section 52, arrangements fall within this section if

(a) the arrangements provide for one person ('the bond-holder') to pay a sum of money ('the capital') to another ('the bond-issuer'),

(b) the arrangements identify assets, or a class of assets, which the bond-issuer will acquire for the purpose of generating income or gains directly or indirectly ('the bond assets'),

(c) the arrangements specify a period at the end of which they cease to have effect ('the bond term'),

(d) the bond-issuer undertakes under the arrangements.

(i) to dispose at the end of the bond term of any bond assets which are still in the bond-issuer's possession,

(ii) to make a payment at the end of the bond term to the bond-holder by way of repayment of the capital ('the redemption payment'), and

(iii) to pay to the bond-holder other payments on one or more occasions during or at the end of the bond term ('additional payments'),

(e) the amount of the additional payments does not exceed an amount which would be a reasonable commercial return on a loan of the capital,

(f) under the arrangements the bond-issuer undertakes to arrange for the management of the bond assets with a view to generating income sufficient to pay the redemption payment and additional payments,

(g) the bond-holder is able to transfer the rights under the arrangements to another person (who thereby becomes the bond-holder),

(h) the arrangements are a listed security on a recognised stock exchange (within the meaning of section 1005 of ITA 2007), and

(i) the arrangements are wholly or partly treated in accordance with international accounting standards as a financial liability of the bond-issuer (or would be if the bond-issuer applied those standards).

(2) For the purposes of subsection (1)

(a) the bond-issuer may acquire bond assets before or after the arrangements take effect,

(b) bond assets may be property of any kind, including rights in relation to property owned by someone other than the bond issuer,

(c) the identification of the bond assets mentioned in subsection (1)(b) and the undertakings mentioned in subsection (1)(d) and (f) may (but need not) be described as, or accompanied by a document described as, a declaration of trust,

(d) a reference to the management of assets includes a reference to disposal,

(e) the bond-holder may (but need not) be entitled under the arrangements to terminate them, or participate in terminating them, before the end of the bond term,

(f) the amount of the additional payments may be.

(i) fixed at the beginning of the bond term,

(ii) determined wholly or partly by reference to the value of or income generated by the bond assets, or

(iii) determined in some other way,

(g) if the amount of the additional payments is not fixed at the beginning of the bond term, the reference in subsection (1)(e) to the amount of the additional payments is a reference to the maximum amount of the additional payments,

(h) the amount of the redemption payment may (but need not) be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income generated by them, and

(i) entitlement to the redemption payment may (but need not) be capable of being satisfied (whether or not at the option of the bond-issuer or the bond-holder) by the issue or transfer of shares or other securities.

(3) An order under section 1005 of ITA 2007 (recognised stock exchanges: designation) may designate a stock exchange for the purposes of that section in its application.

(a) generally, or

(b) for the purposes of this section only.

#### **48B Alternative finance arrangements: alternative finance investment bond: effects**

(1) Additional payments under arrangements falling within section 48A are alternative finance return for the purpose of this Chapter (subject to the provisions in section 51A about the treatment of discount).

(2) For the purposes of an enactment about any tax (and irrespective of the position for other purposes).

(a) a bond-holder shall not be treated as having a legal or beneficial interest in the bond assets,

(b) the bond-issuer shall not be treated as a trustee of the bond assets,

(c) profits and gains accruing to the bond-issuer in connection with the bond assets are profits and gains of the bond-issuer and not of the bond-holder (and do not arise to the bond-issuer in a fiduciary or representative capacity),

(d) payments made by the bond-issuer by way of redemption payment or additional payment are not made in a fiduciary or representative capacity, and

(e) a bond-holder shall not be entitled to relief for capital expenditure in connection with bond assets.

(3) Arrangements falling within section 48A are securities for the purposes of any enactment about tax (including Chapters 1 to 5 of Part 7 of ITEPA 2003); for which purpose.

(a) a reference to redemption shall be taken as a reference to making the redemption payment,

(b) a reference to interest shall be taken as a reference to alternative finance return, and

(c) for the purposes of section 84 the bond issuer shall be treated as being party as debtor to a capital market arrangement.

(4) Arrangements falling within section 48A are a corporate bond, issued on the date on which the arrangements are entered into, for the purposes of section 117 of TCGA 1992 (qualifying corporate bonds) if

- (a) the capital is expressed in sterling,
- (b) the arrangements do not include provision for the redemption payment to be in a currency other than sterling,
- (c) entitlement to the redemption payment is not capable of conversion (directly or indirectly) into an entitlement to the issue of securities apart from other arrangements falling within section 48A, and
- (d) the additional payments are not determined wholly or partly by reference to the value of or income generated by the bond assets;

and section 117(2) shall have effect for the purposes of this subsection as for the purposes of section 117(1).

(5) Arrangements falling within section 48A shall not be treated.

- (a) as a unit trust scheme for the purposes of TCGA 1992,
- (b) as a unit trust scheme for the purposes of section 469 of ICTA or section 1007 of ITA 2007 (distributions),
- (c) as an offshore fund for the purposes of Chapter 5 of Part 17 of ICTA (offshore funds), or
- (d) as a relevant holding for the purposes of paragraph 4 of Schedule 10 to FA 1996 (loan relationships: collective investment schemes).

(6) A bond-issuer is not a securitisation company for the purposes of section 83 (unless it is one by virtue of arrangements which do not fall within section 48A).

(2) Chapter 5 of Part 2 of FA 2005 (alternative finance arrangements) is amended as follows.

(3) In section 46 (introduction)

- (a) in subsection (1) after '47A' insert '48A' and
- (b) in subsection (2) after paragraph (d) (before the 'or' immediately after it) insert.  
'(da) a bond-issuer within the meaning of section 48A below, but only in relation to any bond assets which are rights under arrangements falling within section 47A'.

(4) In section 50(1) (treatment of alternative finance arrangements: companies) for 'or 47A' substitute '47A or 48A'.

(5) After section 51 (treatment of alternative finance arrangements) insert.

### **51A Discount**

(1) This section applies where part of the additional payments in respect of arrangements falling within section 48A equates in substance to discount ('the discount element').

(2) The discount element shall not be treated as alternative finance return for the purposes of income tax.

(3) The discount element shall be treated.

(a) in accordance with section 381 of ITTOIA 2005, or  
(b) where the arrangements falling within section 48A are deeply discounted securities for the purpose of Chapter 8 of Part 4 of ITTOIA 2005, in accordance with that Chapter.

(6) In section 52 (provision not at arm's length)  
(a) in subsection (1) after '47A', insert '48A'.  
(b) in subsection (3) after '47A', insert '48A' and  
(c) in subsection (4) for 'or 47A' substitute '47A or 48A'.

(7) In section 53 (sale and purchase of asset)  
(a) in subsection (1) (and in the heading) for 'or 47A' substitute '47A or 48A', and  
(b) in subsection (3) after '47A' insert 'or 48A'.

(8) In section 54 (return not to be treated as distribution).  
(a) the existing text becomes subsection (1),  
(b) after that subsection insert.

'(2) Neither additional payments nor any part of the redemption payment under arrangements falling within section 48A are to be treated by virtue of section 209(2)(e)(iii) of ICTA as being a distribution for the purposes of the Corporation Tax Acts', and

(c) the heading becomes 'Return not to be treated as distribution'.

(9) In Schedule 2 (supplementary provision) in paragraph 1(b) (definition of 'relevant arrangements') after 'section' insert '48A'.

(10) After section 117(6C) of TCGA (qualifying corporate bonds) insert

'(6D) Section 48B(4) of the Finance Act 2005 (alternative finance arrangements) provides for certain arrangements falling within section 48A to be a corporate bond for the purposes of this section'

(11) In section 127(1)(ca) of FA 1995 (persons not treated as UK representatives) for subsection (5) of section 47, substitute 'Chapter 5 of Part 2'.

(12) In section 148(5A) of FA 2003 (meaning of .permanent establishment.) for 'subsection (5) of section 47' substitute 'Chapter 5 of Part 2'.

(13) Section 56 of FA 2005 (commencement and transitional) shall have effect in relation to the commencement of this section.

(a) as if references to Chapter 5 of Part 2 of that Act were references to this section,

(b) as if references to 6th April 2005 were references to

(i) 1st April 2007 in relation to corporation tax, and

(ii) 6th April 2007 in relation to income tax and capital gains tax,

and

(c) as if references to section 49 were references to sections 48A and 48B.

(14) But

- (a) for the purposes of income tax and capital gains tax in relation to the disposal after 6th April 2007 of arrangements to which new section 48A applies (whenever entered into) that section and new section 48B shall be treated as always having had effect, and
- (b) an order made after the passing of this Act under section 1005 of ITA 2007 (recognised stock exchanges: designation) and by virtue of new section 48A(3) may be expressed
- (i) to have effect as from 1st April 2007 for the purposes of arrangements entered into on or after that date, and
- (ii) for the purposes mentioned in paragraph (a), as always having had effect.

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## 2. DRAFT EXPLANATORY NOTE

### CLAUSE xx: ALTERNATIVE FINANCE: ALTERNATIVE FINANCE INVESTMENT BONDS

#### SUMMARY

1. Clause xx extends the legislation on alternative finance arrangements enacted in Finance Act ("FA") 2005. It provides for an "alternative finance investment bond", which is economically equivalent to a debt security, to be taxed in the same way as a conventional security.

#### DETAILS OF THE CLAUSE

2. Subsection (1) inserts new sections 48A and 48B into FA 2005. New section 48A sets out the conditions which must be present for arrangements to be treated as an "alternative finance investment bond". New section 48B sets out the effects, for tax purposes, where such arrangements fall within new section 48A.
3. New section 48A(1) provides that, subject to section 52 (provisions not at arm's length) arrangements fall within section 48A if they meet a number of conditions. Broadly, these conditions replicate the circumstances in which a person subscribes for a conventional listed debt security, and from which they receive a return that may include interest and other amounts on redemption.
4. Under typical arrangements for an alternative finance investment bond, the issuer uses the subscription proceeds of the bond to acquire assets, which are held for the benefit of the bond holders. Income generated from the assets is distributed to the bond holders and, on maturity of the bond, the assets are sold under pre-existing arrangements and the proceeds returned to the bondholders. The statutory conditions in new section 48A are intended to replicate such typical arrangements.
5. In order to achieve this, new section 48A(1) defines arrangements that fall within the section as those where a "bond holder" pays a sum of money ("capital") to a "bond issuer". It requires the arrangements to specify the assets that are acquired and managed by the bond issuer to generate a return for the bond holder. Such income or gains may be generated directly, for example by

leasing property held by the bond issuer, or indirectly, for example by the bond issuer participating in a joint venture.

6. At the end of the period for which the arrangements have effect, the bond issuer must make a “redemption payment” to repay the capital. Other payments made by the bond issuer to the bond holder, including any premium paid on redemption, are termed “additional payments”. It is a requirement that these additional payments do not exceed a “normal commercial return” from making a loan. This is to exclude arrangements where the return to bond holders is linked to the profits of a business, and which in economic terms are more like partnerships or conventional collective investment schemes. Further requirements are that the bond is transferable, listed on a recognised stock exchange, and accounted for as a financial liability (using the definition of “financial liability” given by International Accounting Standards).
7. New section 48A(2) expands upon and qualifies the conditions set out in new section 48A(1), and allows for a range of types of alternative investment bond.
8. New section 48A(2) allows for cases where the assets are acquired before or after the arrangements set out in new section 48A(1) begin, and where the assets are in the nature of rights, such as a share in a partnership. The arrangements may be accompanied by a declaration of trust, as is typically the case, but do not have to be. Managing the assets includes a reference to their disposal. The bond holders may or may not be entitled to terminate the arrangements. The return from the bond may be fixed, floating, or determined in some other way. If not fixed at the beginning of the bond term, the normal commercial return which is a specified condition for arrangements to fall within new section 48A is a reference to the maximum amount of the additional payments made to the bond holder. The redemption payment is not required to be the full amount of the face value of the bond. These last two provisions reflect the fact that alternative investment bonds do not constitute a debt. Bond holders are not absolutely guaranteed to receive the expected amount of additional payments, or the full redemption payment, and have recourse only to the bond assets. The bond may be convertible into, or exchangeable for, shares or securities.
9. New section 48A(3) allows a stock exchange on which alternative investment finance bonds are listed to be recognised for the purposes of the Tax Acts by an order under section 1005 of the Income Tax Act 2007 (“ITA”). It allows such an order to designate a stock exchange for the purposes of section 48A only. This is to enable exchanges on which existing issues of alternative finance bonds are listed to be designated, without necessarily recognising such exchanges for all Tax Acts purposes.
10. New section 48B(1) provides that additional payments within section 48A are “alternative finance return” for the purposes of Chapter 5 of Part 2 FA 2005, and thus taxed as if they were interest for the purposes of the Income Tax (Trading and Other Income) Act 2005 (“ITTOIA”). This is subject to a new section 51A of FA 2005.

11. New section 48B(2) provides that, whatever the documentation accompanying the arrangements may say, for tax purposes the bond holder is not treated as having a legal or beneficial interest in the assets, and is not entitled to capital allowances, nor is the bond issuer treated as a trustee, or as making payments in a fiduciary or representative capacity.
12. New section 48B(3) provides that alternative finance investment bonds are securities, for the purposes of any enactment about tax. For example, they will be treated as securities for the purposes of tax rules on “deeply discounted securities”, and securities acquired in connection with employment.
13. New section 48B(4) provides that an alternative finance bond is a corporate bond for the purposes of the Taxation of Chargeable Gains Act 1992 (“TCGA”), provided it satisfies conditions that are similar to those in section 117(1) TCGA 1992. That is, the bond must be expressed in and only capable of redemption in sterling; if convertible, it should be convertible only into other alternative finance bonds; and the return must not be determined by reference to changes in the value of the assets underlying the bond arrangements. This is relevant where alternative finance investment bonds are held by individuals: where these conditions are met, they will be qualifying corporate bonds (QCBs) and their disposal will be exempt from capital gains tax.
14. New section 48B(5) provides that tax rules on unit trust schemes, offshore funds and collective investment schemes do not apply to arrangements within new section 48A. This is necessary because many alternative finance investment bond arrangements fall within the definition of “collective investment scheme” in the Financial Services and Markets Act 2000.
15. New section 48B(6) provides that the bond issuer is not a “securitisation company” within section 83 FA 2005. It will not therefore be subject to the temporary tax rules that apply to such companies.
16. Subsection (2) introduces amendments to Chapter 5 of Part 2 of FA 2005.
17. Subsection (3) extends the definition of “alternative finance arrangements” within section 46(1) FA 2005 to include arrangements within section 48A, and amends the definition of a “financial institution” within section 46(2) to include a bond issuer, but only where the assets are those within specified other alternative finance arrangements.
18. Subsection (4) amends section 50(1) FA 2005 to extend the tax treatment that applies to a company that is party to alternative finance arrangements to apply also to a company that is a bond holder or bond issuer within section 48A. This means that for companies – whether they are holders or issuers of alternative finance bonds – the arrangements are treated as loan relationships.
19. Subsection (5) inserts new section 51A into FA 2005. This section modifies the normal rule that additional payments are to be taxed as alternative finance return. Instead, where any part of the additional payment equates in substance to a discount, that element of the additional payment is to be taxed in accordance with normal tax rules that apply to discounts, including the rules on

deeply discounted securities. The requirement to deduct tax, which applies to alternative finance return that is treated as if it were interest, will not therefore apply to the discount element.

20. Subsection (6) amends section 52 FA 2005 (provision not at arm's length) to extend the existing anti-avoidance provisions to cover section 48A arrangements.
21. Subsection (7) amends section 53 FA 2005 (sale and purchase of asset) so that amounts within section 48A which are taxable as if they were interest are excluded, like other returns from alternative finance arrangements, from amounts taxable under the rules on capital gains tax.
22. Subsection (8) amends section 54 FA 2005 (profit share return not to be treated as distribution) so that payments made under section 48A, like other returns from alternative finance arrangements, are not treated as distribution under section 209(2)(e)(iii) of the Income and Corporation Taxes Act 1988 ("ICTA"). It also amends the heading to section 54 FA 2005 so that it refers to both profit share return within sections 49 and 49A FA 2005, and the return from section 48A arrangements.
23. Subsection (9) applies Schedule 2 to FA 2005 to arrangements under section 48A. This schedule deals with more detailed aspects of treating the return from alternative finance arrangements as if it were interest, including the requirement to deduct tax.
24. Subsection (10) inserts a new section 117(6D) into the TCGA. This provides that certain arrangements falling within new section 48A are to be treated as corporate bonds for the purposes of section 117 TCGA.
25. Subsection (11) amends section 127(1)(ca) FA 2005, which prevents a non-UK resident individual investor in a section 48A from being treated as trading in the UK through a UK representative, so that it refers generally to alternative finance arrangements within Chapter 5 of Part 2 FA 2005 rather than to particular sections of FA 2005.
26. Subsection (12) amends section 148(5A) FA 2003, which prevents a non-UK resident corporate investor in section 48A from being treated as having a permanent establishment in the UK, so that it refers generally to alternative finance arrangements within Chapter 5 of Part 2 FA 2005, rather than to particular sections of FA 2005.
27. Subsection (13) amends section 56 FA 2005 (commencement and transitional) so that the commencement date for sections 48A and 48B are 1 April 2007 for corporation tax purposes and 6 April 2007 for income tax purposes.
28. The existing section 56 FA 2005 contains transitional provisions for arrangements within sections 49 FA 2005, which apply to arrangements that straddle 1 April (in the case of corporation tax and 6 April (in the case of income tax), and these are applied to arrangements within section 48A. For corporation tax, an arrangement within section 48A is treated as a loan made to or by the

company at its notional carrying value at 1 April. For income tax, only amounts received after 6 April are taxable as if they were interest by virtue of section 51 FA 2005.

29. Subsection 14 provides that on disposal of an existing alternative finance investment bond by a non-corporate person, the provisions of section 48A and 48B, including treatment of the arrangements as a QCB where appropriate, are deemed always to have had effect. This will enable the appropriate capital gains tax computational provisions to operate correctly. The subsection also allows the designation of a recognised stock exchange to have effect from 1 April 2007, or deems it always to have had effect in connection with the disposal by a non-corporate person.

### **BACKGROUND NOTE**

30. This clause extends and modifies the provision in sections 46 to 57 FA 2005. The main effect of the clause is to apply the tax rules on alternative finance arrangements to a form of Shari'a compliant investment bond (known in the plural as 'sukuk' – singular 'sakk') that is, in economic substance, similar to a debt security. Sukuk arrangements allow assets to be held for the benefit of investors in certificates issued by a company. The benefits may include the payment of a return that is economically equivalent to interest and redemption of the certificates out of the proceeds from the disposal of the assets.
31. The clause applies to sukuk which meet conditions that make them economically equivalent to a conventional bond, and which are listed on a recognised stock exchange.
32. Amounts payable by a company that issues sukuk that fall within the legislation are to be relieved for tax purposes under the tax rules on loan relationships, in a manner that is the same as interest and other amounts to which the loan relationship rules apply. A corporate holder of such a bond is similarly taxable on amounts receivable in respect of the sukuk under the loan relationships rules.
33. A person who is taxable under income tax rules is taxable on amounts received from a sukuk that falls within the legislation as if the amounts were interest. Where such a person transfers the bond to another person they are to be treated for capital gains tax purposes as if they had disposed of a security.
34. Sukuk are similar in many respects to collective investment schemes. To put their tax treatment beyond doubt, this measure ensures that sukuk that meet the specified conditions are not subject to the tax rules on such schemes. It also ensures that the holders of sukuk are not taxable on the income from the assets held for their benefit and are not entitled to capital allowances.